DOW THEORY LETTERS INC.

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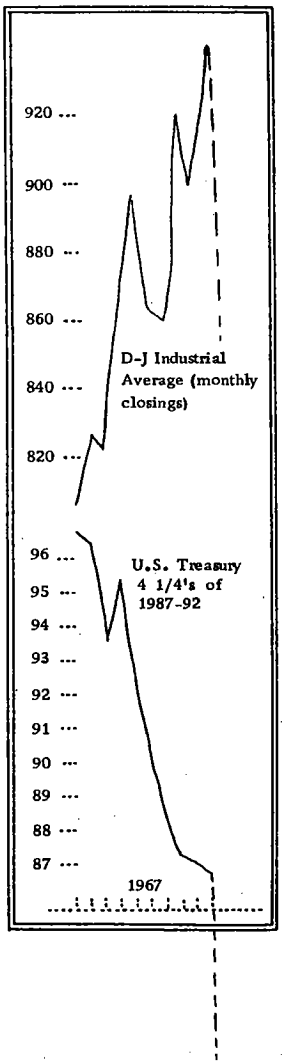
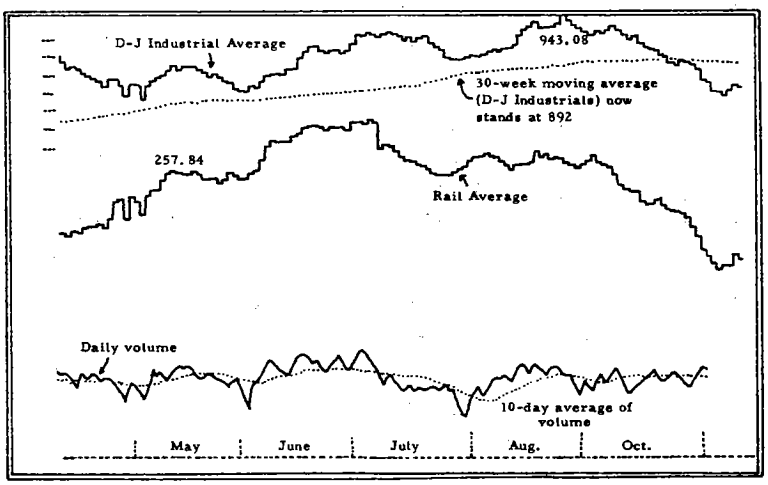
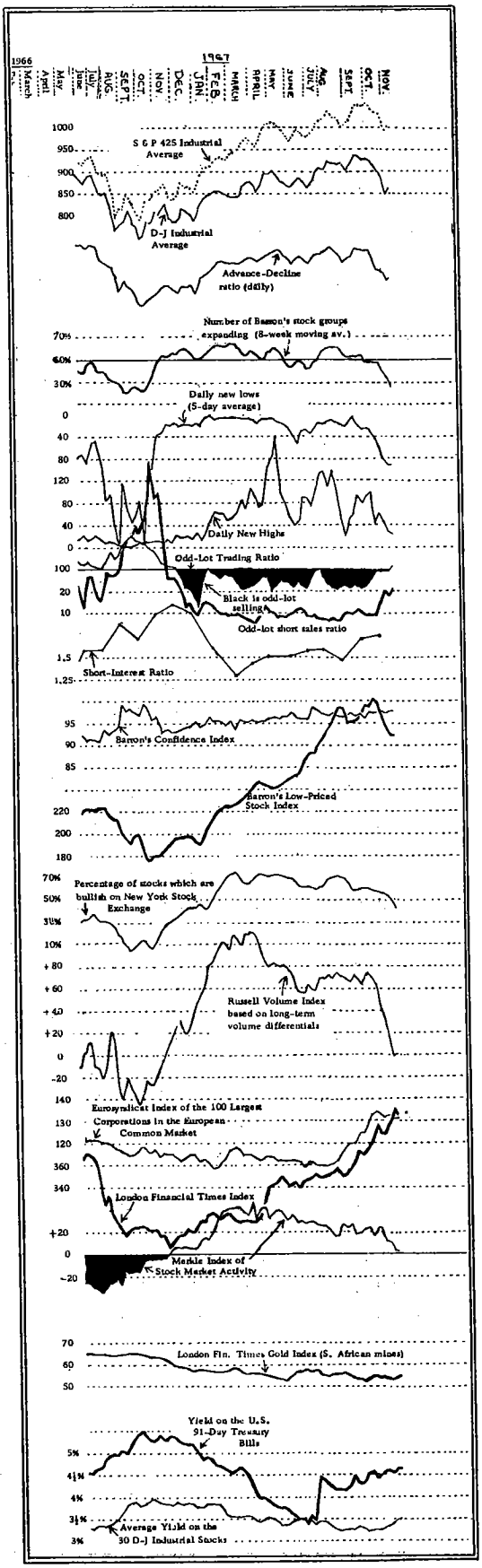
THE MARKET: In Letter 371 (October 4) I included a chart entitled, "....the dilemma of the investment markets today." The chart showed the monthly closings of both the D-J Industrial Average and the bellwether of the Treasury bond market, the 4¼ of 1987-92. The action in these two components since October 4 has been most dramatic, and I am updating that chart with this Letter. The dashed line shows the price change in the Dow and the 4¼ bond since October 4.



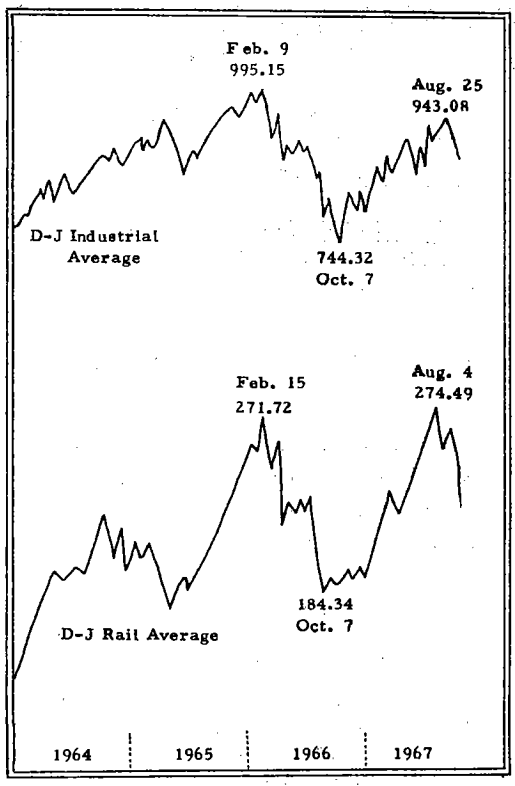
In a little over a month, the 4¼'s have tumbled off the bottom of my chart to close in the 81 area. The Dow (as I suggested it would) has also declined sharply, thereby raising the average yield on the senior Average to last week's 3.5%. At 3.5% the yield on the Dow is hardly inviting by historical standards, but at least the yields have increased. From the October 4 price of 87, the 4¼'s have dropped a fantastic 6 points (actually $60) to last week's price of 81. This means that this bond too, has seen its yield rise from 5.2% to 5.6%. In "normal" markets the bond sector can be expected to rally when stocks fall, thus tending to correct any adverse yield spread between stocks and bonds. But today's market is anything but normal.

Due to the jettisoning of the surtax bill, the general lack of rapport which now exists between Congress and the White House, the onrush of new financing and the continuance of heavy spending in all areas, the bond market now lies in shambles. We have been witnessing the rare




1966
1967
S & P 425 Industrial Average
D-J Industrial Average
Advance-Decline ratio (daily)
Number of Barron's stock groups expanding (8-week moving av.)
Daily new lows (5-day average)
Daily New Highs
Odd-Lot Trading Ratio
Black is odd-lot selling
Odd-lot short sales ratio
Short-Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Percentage of stocks which are bullish on New York Stock Exchange
Russell Volume Index based on long-term volume differentials
Eurosyndicat Index of the 100 Largest Corporations in the European Common Market
London Financial Times Index
Merkle Index of Stock Market Activity
London Fin. Times Gold Index (S. African mines)
Yield on the U.S. 91-Day Treasury Bills
Average Yield on the 30 D-J Industrial Stocks

sight of the bond market and the stock market declining in unison. Thus, the adverse stock-bond yield spread has not only held, it has increased. In the past month the yield spread between the 30 Dow stocks and the 4¼ bond has actually increased from October 4th's negative yield spread of 2.0% to today's negative yield spread of 2.1%. From a standpoint of comparative yields, then, nothing has been corrected by the 85 point drop in the Dow which has occurred since the September high.



From another standpoint, what the September-November drop in the Dow is discounting is a continuing and probably intensifying squeeze on corporate earnings. The First National City Bank of N.Y., in a late report, shows that the third quarter of 1967 produced an overall earnings drop of 6% as compared with the third quarter of 1966. Particularly severe was the drop in Rail earnings, a total drop of 55%. For instance, Chicago Northwestern and N.Y. Central showed actual deficits in the third quarter while Pennsylvania and Great Northern showed drops of 41% and 52% respectively.

Turning to the stock market itself, I think it is extremely important for my readers to understand that we have recently witnessed what I term a "double non-confirmation" in the Averages. In my experience and in my years of studying the Averages, I would say that the double non-confirmation constitutes the most powerful type of reversal formation. Yet strangely, almost no one has recognized or written about this phenomenon.

Note on the accompanying chart that the last confirmed highs of the 1949-1966 bull market were struck in February, 1966. Following those highs we had the first major decline in the bear market, a decline which carried to October, 1966. A remarkable recovery followed, and by August 4 the Rail Average had risen to a new all-time high of 274.49. This was three points above the 1966 Rail peak (271.72). Industrials, however, failed by 52 points in confirming. This was a non-confirmation of major or primary importance.

Within the framework of this huge non-confirmatory structure, a second non-confirmation took place as follows. Following the August, 1967 peaks (see chart of Averages on page 1), the Industrials and Rails turned down, striking lows on August 30. A new advance got underway, and on September 25, Industrials recorded a 1966-67 recovery high (not an all-time high) of 943.08. This time Rails failed by a wide margin to better their own August high. Thus a secondary non-confirmation occurred within the structure of the major 1966-67 non-confirmation.

In other words, Industrials refused to confirm the Rails, in that Industrials failed in 1967 to better their 1966 highs. Then Rails refused to confirm Industrials, in that Rails during September, 1967, refused to better their preceding August highs. This entire pattern constitutes the double non-confirmation. Such patterns are rare, but in my experience they carry reversal implications of major import.

On the nearer term, as of November 6, the Rail Average had closed down on 23 of the previous 24 trading days. This is something of a record, an absolutely incredibly bad performance. The Industrials during the same period closed down on 22 of the preceding 24 trading days. The obvious implication is that the market is "oversold," and is way overdue for a rally. On November 8 the market indeed mounted its first promising rally since the September high. It would not be abnormal to see the rally continue for a few weeks or longer, but I continue to feel that the back of the 1966-67 recovery movement has been shattered.

Some of our technical data is well worth noting at this time. The Russell Volume Index, which has been correctly issuing warnings since early October, broke to a minus 1 on November 3. I have been calling attention to the ominous descending zig-zag in this Index, but the rate of decline since October (see page 1 composite chart) is the steepest on record. In the past seven years, the Russell Index has broken below zero only three times, in 1962, 1965 and 1966. The area below zero is what I term the potential "crash area," and it is in this negative territory that the worst part of previous cave-ins have occurred.

As a point of interest, the Russell Volume Index stayed negative for 15 weeks in 1962, for 7 weeks in 1965. In 1966 the Index turned negative for 5 weeks, changed to positive for 2 weeks, then switched to negative for an additional 13 weeks. Although the past is no certain guide to the future, the suggestion here is that when the Index turns negative, we can expect a period of 5 to 15 weeks of additional negative action. Or to put it another way, any time the Index goes below zero (as it has just done), the expectation should be of a serious decline, on the order of 1962, 1965 or 1966.

The Merkle Index dropped to plus 5 last week, its lowest level since November, 1966. This Index flashes danger when it drops below zero, and this it has not yet done. The Merkle Index last turned negative in March, 1966, hitting its extreme low during

the month of July at minus 34.

The 5-day average of new highs dropped to 24 on November 7, thus cracking the 26 level of last June. At 24, the daily new highs have sunk to their lowest level since January. At the same time the 5-day average of new lows (see composite page 1 chart) has expanded to 93, which is its highest level since October, 1966. The implications of these two indexes is that selling pressure (as evidenced by new lows) is now coming in strongly, while buying power (new highs) has finally subsided.

So far, however, I feel that the speculative back of this market is still largely intact. There has been no widescale disillusionment with the glamor issues and the high flyers. In most cases, they have held up better than the Dow stocks on the downside. On the Amex too, although many stocks have formed tops, the many incredible "stilt formations" are still in effect. When the real speculative structure of this market gives way, we should see widespread slaughter in the "cats-and-dogs" with the stilt formation smashing and with huge gaps between the bid and asked price of these issues.

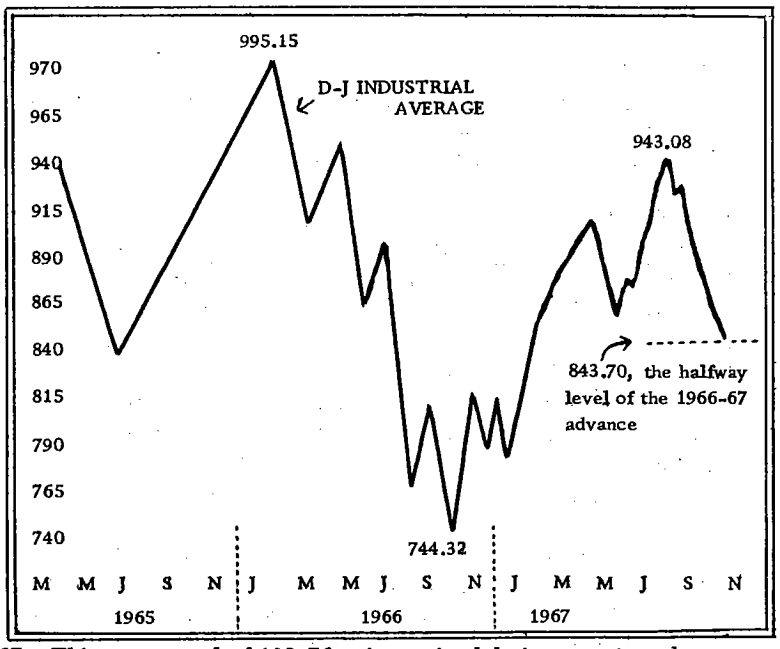
A study of the daily charts on the N.Y.S.E. (I have used Traders Research, 101 Cherry St., Alton, Ill.) shows the majority of stocks now in distribution formations with many head-and-shoulder tops and descending triangles. For the first time since 1966, it appears to me that the technical picture (seen from the standpoint of individual issues) has shown sufficient deterioration to allow for general bearishness regarding the market. In other words, I feel that so many stocks have now broken down technically that there is little chance of a forthcoming recovery to new highs.

Note also that the advance-decline ratio (page 1 composite chart) has wiped out all gains back to January of 1967. This would imply that the majority of stocks on the N.Y.S.E. have given back all gains for 1967. It would suggest that the average broad portfolio shows little or nothing in the way of gains for this year.

In the convertible bond market, the picture is much the same if not worse. Worse because many convertible holders are also speculators, and many of them have been holding their bonds on very thin margins. Not only have these bonds declined in sympathy with the stocks into which they are convertible, but the "floor" under these bonds (the floor being the bond coupon or the pure bond yield) has sunk as the interest structure of the entire bond market has given way. Thus, a convertible with say a 4.25% coupon would have held well (as a strict bond) during 1957, at which time the stock market broke but interest rates actually declined. But the same 4.25% bond during the market decline of 1967, has declined both as its common stock declined and as its value as a bond has declined. This double-barreled assault on the convertible market has produced vicious losses in a variety of issues. On top of this, the projected new restrictions on convertible financing has thrown a chill over the convertible market, and if nothing else the new high margins will greatly reduce volume of turnover in convertible issues.

50% PRINCIPLE: According to Dow's 50% Principle, it is most important to observe what the Industrial Average does at the halfway or 50% level of preceding major, extended advances or declines. According to the Principle, if an advance succeeds in bettering the halfway level of the preceding major decline, the odds favor a testing of the old highs again. Conversely, if an advance halts under the halfway level of the preceding major decline, the odds favor a return to the preceding lows again.

The same concept can be used to gauge the importance of a decline. In the present instance, we have the decline which began on September 25, at 943.08 on the Dow. At what point would the 50% Principle become operative?



The preceding major movement was the 1966-67 advance, an advance which started at 744.32 in October, 1966, and carried to 943.08 in September, 1967. This was a total of 198.76 points gained during a major advance. The halfway level of the 1966-67 advance is 744.32 plus half of the 198.76 points gained—or 843.70.

Therefore, the 843.70 level became the critical point under the 50% Principle. It is now of utmost importance to observe whether the current sell-off will hold stubbornly above the 843.70 area, or whether the decline breaks decisively below 843.70, thereby wiping out better than half of the 1966-67 gains. If the Dow were able to hold persistently above 843.70,

then according to the 50% Principle the odds would favor a strong rally with a possibility of an approach or even a bettering of the 1967 high of 943.08. On the other hand, if the Dow were to close decisively below 843.70 the implications would be quite bearish, suggesting that in due time the Dow would approach or violate the 1966 low of 744.32.

INCIDENTAL INTELLIGENCE: Last week, as the U.S. lost another $100 million of gold and the U.S. gold position (now under $13 billion) dropped to its lowest level in 30 years, the Federal Reserve ratio sank to 30.5, its lowest point yet. The statutory limit is 25%, and as we near that point the pressure will mount to free all gold for foreign claims. This would mean no gold backing whatsoever behind the U.S. currency, which would then become complete fiat money.

One friend of mine, Irving Weiss (publisher of Capital Advisers) believes that the U.S. will be forced to and willing to defend the dollar, and that one result will be skyrocketing interest rates, rates that will "draw money from the moon." If Weiss is right, then deflation (rather than inflation) will reign king over the next few years as the U.S. gold position and the dollar is defended and the water is squeezed out of Wall Street and the economy. I, personally, take more of the view that the pressure of drastic events will cause the U.S. to move, rather than any conscious, planned policy.

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In many critical areas, the U.S. seems to be drifting aimlessly out of control. This seems to be true on the political front where there is less and less rapport between the President and Congress. On the war front, the rumor is that McNamarra is ready to resign and that the Pentagon would like nothing better. No one seems to know what our war policy is any more, and as we near election time the feeling is that LBJ will have to draw a rabbit out of the hat. As I have written many times before, Hanoi has written off LBJ as far as negotiations are concerned. They feel he is too committed to be able to offer any acceptable peace terms. On the monetary front, the Treasury dilemma of more taxes or less money, both or neither, leaves most students bewildered. The general feeling is that the Fed is as bewildered as everyone else.

* * * *

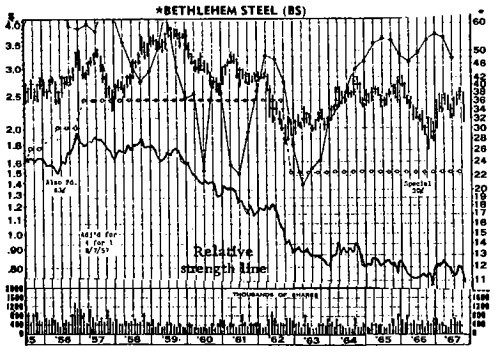
I see the following as contributing towards an increasing 1968 squeeze on corporate profits: (1) Labor costs are rising, (2) productivity gains are dropping sharply, (3) Severe competition is preventing many corporations from raising prices to cover cost-of-labor boosts and productivity drops, (4) the supply of labor is being restricted by the Vietnam war, thus pushing up costs of hiring and pushing up general training costs.

Case in point is mighty DuPont, which is now (probably for the first time in its history) facing severe competition. This year profits in the first three quarters for DuPont dropped 25%, and the rumor is that DuPont might omit the traditional year-end dividend. DuPont has (unlike its competitors) avoided heavy borrowing for expansion purposes. But now it appears that DuPont, too, may hit the borrowing-expansion trail—in the face of the highest money rates in a generation.

* * * *

Along these same lines, the aerospace industry is now feeling the pressure of Congressional cutbacks. The industry is laying off workers at the rate of 5,000 per month, and NASA is eliminating one quarter of its 20,000 potential suppliers. The White House has told NASA not to look towards it as a source of new funds. The pressure is on the White House for reductions in spending in all areas (this, a result of the President's halfhearted backing of the tax bill).

STOCK COMMENTS: Bethlehem Steel (BS) during 1957-62 formed one of the largest "head-and-shoulders" tops on the record. That top smashed in 1962, at the 36 level (see monthly chart from Securities Research, 208 Newbury St., Boston, Mass.). Twice, in 1964 and again in 1966, BS attempted to push above the 36 level, but each time the stock fell back. Currently, BS is back in the 31 area. Note that the relative strength line in BS has been declining for an amazing 10 years. My guess is that a good deal of the adverse conditions in the steel industry have now been discounted by BS and other steel stocks. Within a year or so (at the ultimate bear market bottom) I would expect BS to be a great buy.



American Telephone (T) is now showing another huge head-and-shoulder. A break to 49 would complete this top. T's relative strength line has been declining since 1963. I would avoid this issue, as I feel that T is roughly where BS was in 1962. Something is drastically wrong with T, and the real shakeout has not yet occurred.